In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 70-273

JOHN F. KAPPEL, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The findings of fact and conclusions of law of the district court (Pet. App. 15a-32a) are reported at 281 F. Supp. 426. The memorandum opinion of the district court denying a motion for a new trial (Pet. App. 33a-36a) is not reported. The opinion of the court of appeals (Pet. App. 1a-11a) is reported at 437 F. 2d 1222.

JURISDICTION

The judgment of the court of appeals was entered on February 1, 1971 (Pet. App. 12a-13a). A petition

for rehearing *en banc* was denied on March 19, 1971 (Pet. App. 14a). The petition for a writ of certiorari was filed on June 14, 1971. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether petitioners were not legally obligated to make repayments of amounts improperly withdrawn from certain pension trusts and, therefore, are not entitled to deduct the amounts repaid pursuant to Section 1341 of the Internal Revenue Code.

STATUTES INVOLVED

The pertinent provisions of Section 1341 of the Internal Revenue Code of 1954 are set forth in the petition (pp. 3-4).

STATEMENT

Petitioners [1] were officers, directors and principal stockholders of four corporations, each of which funded and maintained in Pennsylvania an employees' pension trust. Petitioners were also participating employee beneficiaries of the trusts. Together with their relatives, they constituted a majority of the trustees of each trust. (Pet. App. 3a-4a, 30a.)

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[1] References to "petitioners" are to John F. Kappel and William J. Kappel. Their wives are parties to this action only because joint income returns were filed for the year in issue. William J. Kappel died, and his executors were substituted as parties.

Under the trust plans, the trustees contracted for a separate annuity policy for each participating employee, including petitioners, through general life insurance companies. Each trust provided that benefits could not be paid to a beneficiary in one lump sum; that no beneficiary had any power of anticipation of the policy proceeds; and that no beneficiary could transfer an interest in the proceeds. (Pet. App. 4a.)

Despite these prohibitions, petitioners, on the advice of a reputed pension expert, withdrew from the trusts the proceeds of the annuity policies held for their benefit. The Internal Revenue Service determined, late in 1959, that these withdrawals constituted taxable income to petitioners, and they paid the additional taxes due on the income. (Pet. App. 2a, 4a-5a.)

Petitioners' legal and accounting advisers informed them that, because their withdrawals had violated the trust agreements, they were obligated to restore the funds to the trusts. Although no legal proceedings were instituted to require repayments, petitioners acted on this advice and, in 1960, repaid the amounts previously withdrawn. They claimed deductions for these amounts on their income tax returns for that year, in reliance on Section 1341(a) of the Internal Revenue Code. Insofar as pertinent here, that provision allows a deduction for an amount previously received under claim of right, which is restored, provided that events subsequent to the year of receipt show that the taxpayer "did not have an unrestricted right" to the amount received. (Pet. App. 5a.)

The Commissioner disallowed the claimed deductions on the ground that petitioners were under no

legal obligation to make the repayments. After paying the taxes in dispute, petitioners brought these suits for refund in the district court. That court sustained the Commissioner's determination (Pet. App. 30a-31a), and the court of appeals affirmed (Pet. App. 7a-11a).

ARGUMENT

The decision below is correct. There is no conflict or any other reason for further review.

1. If a taxpayer receives income under a claim of right and without restriction as to its disposition, he must include the income in his tax return for the year of receipt, even though he may be required to repay the money received in a later year. If in fact repayment is required, the taxpayer is entitled to take a deduction on his tax return for the year of repayment. See *North American Oil* v. *Burnet*, 286 U. S. 417, 424; *Healy* v. *Commissioner*, 345 U. S. 278.

Section 1341(a) of the Internal Revenue Code is the statutory successor to the so-called "claim-of-right" doctrine which this Court first enunciated in *North American Oil, supra.* The statute permits a taxpayer who qualifies for the repayment deduction either to take the deduction in the year of repayment, as under prior law, or to recompute, in effect, his income tax for the years in which funds were received, by excluding the amounts received from taxable income for those years. See *United States* v. *Skelly Oil Co.*, 394 U. S. 678, 680-682.

Under the "claim-of-right" doctrine as judicially formulated, and under its statutory counterpart, a

deduction is allowable only if, *inter alia*, there exists a legal obligation to make repayment of the amounts previously received under claim of right. Although it may not be necessary, in order to establish that repayment was required, that a court issue a judgment to this effect, a sufficient obligation must exist as would support a judgment. A voluntary repayment, or one sustained only by a moral obligation is insufficient. See, *e.g.*, *Crellin's Estate* v. *Commissioner*, 203 F. 2d 812 (C.A. 9), certiorari denied, 346 U. S. 873; *United States* v. *Simon*, 281 F. 2d 520 (C.A. 6); *Pike* v. *Commissioner*, 44 T.C. 787.

2. Both courts below correctly held that petitioners were not legally obligated to repay the funds which they had improperly withdrawn from the trusts. Under Pennsylvania law, such an obligation is imposed upon a beneficiary who consents to, or participates in, a breach of trust only if the breach results in a loss to another beneficiary. See *Quest's Estate*, 324 Pa. 230, 188 Atl. 137; Restatement of Trusts 2d, Sec. 256. Petitioners' unauthorized withdrawals in no way impaired or injured the interest of any other beneficiary, since each beneficiary's interest in the trusts was represented by a separate annuity policy.

The Pennsylvania cases upon which petitioners rely are not to the contrary.[2] In any event, there is no

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[2] *Union Trust Co. of New York* v. *Gilpin*, 235 Pa. 524, 84 Atl. 448, *Glauser Estate*, 350 Pa. 192, 38 A.2d 64, and *Maloney* v. *Glosser*, 427 Pa. 548, 235 A.2d 607 (Pet. 12-13), involved situations in which other beneficiaries had been injured by the breach. *Garner* v. *Girard Trust Bank*, 442 Pa. 166, 275 A.2d 359, and *Reilly* v. *Walker Brothers*, 425 Pa. 1, 229 A.2d

reason for review by this Court of the narrow question of state law passed upon by the courts below. Nor is there any basis for further review on the theory that petitioners might be liable as trustees for breach of their fiduciary duties. As the court of appeals observed (Pet. App. 9a-10a n. 8), such liability cannot give rise to a Section 1341 deduction.

3. Petitioners' remaining contentions are equally lacking in merit. Their claim (Pet. 19-26) that they were under a legal obligation to restore the funds because their failure to do so would jeopardize the tax exempt status of the trusts, was fully answered in the opinion of the court of appeals (Pet. App. 9a-10a). As for their suggestion (Pet. 18) of "an apparent conflict in decisions between the Third and Eighth Circuits * * *", it is sufficient to note that the case on which they rely (*First Trust Co. of Saint Paul* v. *United States*, 321 F. Supp. 1025 (D. Minn.)) was decided by a district court, and involves an estate tax question arising under Section 2039 of the Code.[3]

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457 (Pet. 11, 15), in which the court was asked to modify the terms of pension trust instruments, have no bearing on the question whether a beneficiary who consents to, or participates in, a breach of trust is liable to other beneficiaries.

[3] Petitioners erroneously state (Pet. 18) that the *First Trust Co.* case is now pending on the government's appeal. A final determination not to appeal was made on May 11, 1971, more than a month before the instant petition was filed.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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